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ESTATE TAX REPEAL – LEGISLATIVE UPDATE

2010 Tax Repeal Update: For the first time since 1915, United States taxpayers are faced with no federal estate tax. As historic as it may be, this amazing situation is scheduled to last only for 2010, or until sooner corrective measures are taken by Congress (if any). Is this temporary repeal of the estate and generation-skipping transfer ("GST") tax cause for excitement, or is it even good news at all? The answer to that question depends on the actions taken by Congress and the Obama administration in the coming weeks and months.

How We Got Here

The Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Tax Act") was enacted in 2001 by an overwhelming majority of both the House of Representatives and the Senate and signed into law by President Bush. Economic forecasts at the time showed significant budget surpluses, and the impetus of the 2001 Tax Act was to return those surpluses to taxpayers in the form of significant tax cuts. Those cuts increased the federal estate tax exemption from $675,000 to $3.5 million from 2001 to 2009, and during the same period phased reductions in the top federal estate tax rate from 55% to 45%. Under the 2001 Tax Act, all the provisions of the Act "sunset" (in other words, become ineffective) on January 1, 2011. Therefore, for decedents dying, gifts made, or generation-skipping transfers after 2010, "the Internal Revenue Code of 1986 . . . shall be applied and administered . . . as if the provisions and amendments [to the 2001 Tax Act] had never been enacted."

For the past 9 years all attorneys, accountants, and financial planners have assumed that Congress would act responsibly and extend or repeal the provisions of the 2001 Tax Act before the sunset provision took effect. In fact, during the Bush administration there were multiple attempts to make permanent, several provisions of the 2001 Tax Act including a permanent repeal of the federal estate tax. On more than one occasion, the House of Representatives passed a permanent repeal bill, but such a bill could never garner the 60 votes necessary in the Senate to avoid a filibuster (coming as close as 58 of the 60 votes needed in the summer of 2006). Trying to predict how Congress will act with respect to tax policy has been even more frustrating than normal in the last 60 days. Congressional inability to solve this problem before the end of 2009 means that taxpayers have the potential to face three distinctly different estate tax systems within a 13-month period. We had expanded exemptions and reduced rates that applied through December of 2009, we have a temporary repeal for 2010, and then will have a sunset effective January 1, 2011, with a return of the estate tax system essentially in the form it was before the 2001 Tax Act.

Current Law

In general, the federal gift, estate and GST tax provisions during 2010 and 2011 will be the following:

2010 Provisions

- Estate and GST tax repealed.
- Gift tax exemption remains $1 million with the highest marginal gift tax rateequal to the top individual income tax rate (35%).
- Carryover basis regime is instituted with $1.3 million per person exemption, plus potentially a $3 million marital exemption (discussed further below).
- All transfers to trust other than Grantor Trust are treated as completed gifts.
- Distributions after 2020 from, and terminations after 2009 by, Qualified Domestic Trusts (QDOTs) are no longer taxable.

2011 Provisions

- Estate and gift tax exemption returns to $1 million.
- GST exemption is $1 million, indexed for inflation.
- Highest marginal estate and gift tax rate is 55%, plus 5% surcharge on estates in excess of $10 million.
- Maximum state death tax credit is 16%.
- Qualified Family Owned Business Interests (QFOBI) deduction is restored.
- QDOT distribution and termination taxes are restored.

One of the most significant features of the repeal environment is the imposition of carryover basis upon death. Prior to 2010, Internal Revenue Code (the “Code”) § 1014 provided a step-up in basis equal to the fair market value of the asset at the date of death. In 2010, the basis step-up is replaced with the carryover basis system in which assets receive a basis equal to the lesser of the basis of the property in the hands of the decedent or its fair market value on the date of death. The post repeal carryover basis rules provide $1.3 million aggregate basis increase that can be allocated to assets regardless of the recipient, and an additional $3 million spousal basis adjustment allocable to property received by a surviving spouse, either outright or in a qualifying trust. The allocation of the basis adjustment is not to increase the basis of property worth $1.3 million to $1.3 million. Instead, the total adjustment may be divided among various assets. For example, assume the child of a decedent inherits property worth $5 million in which the decedent's basis at death was $1 million. The executor may elect to increase the basis of the property to $2.3 million. If the property were worth only $2 million when the decedent died, the executor could increase the land's basis from $1 million by $1 million to $2 million and could allocate the remaining $300,000 of basis increase to other appreciated property.

Legislative Options

Congress has at least three options to address the current repeal dilemma. First, Congress can continue to do what it has done for the last nine years and not address the one-year repeal of the estate and GST tax. Under this scenario, the rates for 2010 and 2011 would apply as outlined above. Second, and perhaps most likely, Congress may enact a one-year "patch" that would extend the rates and exemptions in effect on December 31, 2009, for one calendar year.

Depending on when this patch is enacted, this could give Congress several months to address a more permanent solution. One question that permeates this discussion is whether the effective date of such a patch would be prospective from the date of enactment or retroactive back to January 1, 2010. Although it may seem illogical, there is sufficient Constitutional authority for a retroactive enactment of estate tax legislation. It seems particularly likely that any quick legislation (January or February) will have a retroactive date back to January 1, 2010, because the potential repeal period would be relatively short. Although the Constitutional authority generally does not hinge on a delay of a few weeks, it appears that it may become politically more difficult to approve retroactive legislation the longer Congress allows the problem to persist (March, April, or beyond).

Third and perhaps the least likely Congressional action, but one that cannot be ruled out at this time, is that Congress would use this opportunity to enact more widespread legislation that would not only reinstate the estate and GST tax but also would make additional changes to the transfer tax system that have been widely debated in the past. In fact, one reason for the December 2009 Congressional deadlock was both parties' desire to see more sweeping changes (either extended exemptions and lower rates by the Republicans or elimination of perceived abuses by the Democrats).

What To Do In 2010

Inaction by Congress means that many current estate plans no longer accomplish the client's original objectives. Specifically, many plans are based on formulas or decisions tied to transfer taxes, and these may be significantly impacted by the current state of legislative confusion. One of the primary objectives when thoughtfully embarking on the estate planning process is to provide some certainty for the disposition of assets at death. **Because the current legislation (or in this case the lack thereof) has the potential to completely undermine the intended disposition of a client's assets, it seems imperative that the short term objective must be to review these documents to ensure that the client's intentions and wishes are respected**. As a beginning, many wills and revocable trusts contain references to the Internal Revenue Code and use funding language tied to definitions or provisions found in the Code. Examples include “maximum marital deduction”, “applicable exclusion within the meaning of Section 2010(c) of the Code”, and “unified credit amount.” Uncertainty exists where words and concepts used in a formula to define the size of a bequest are no longer a part of the Code. How will this impact funding?

Most married clients have estate planning documents implementing a formula to fund a Family Trust with the decedent spouse’s unused applicable exclusion and a Marital Trust with the balance of the estate. The original intent in this situation is to fund the Family Trust with a limited amount determined by the decedent’s applicable exclusion ($3.5 million) in December 2009, which would be sheltered from federal estate tax in both spouses’ estates. It now appears in January 2010 that the entire estate of the decedent would be transferred to the Family Trust and there would be no funding for the Marital Trust. Whether this creates a problem for the decedent (or more specifically the surviving spouse) depends on the terms of the Family Trust, the trustee of the Family Trust, the permitted discretionary beneficiaries of the Family Trust, and in some circumstances whether there is significant appreciation in the decedent’s estate. The latter point can be relevant in the event the terms of the Family Trust would not qualify for the additional $3 million allocation basis available for assets otherwise passing to or for the benefit of the surviving spouse.

Other clients may have estate plans that use charitable gifts or techniques such as charitable remainder trusts or charitable lead trusts designed to minimize estate taxes in an otherwise taxable estate. The temporary repeal of the federal estate tax not only impacts the potential funding of these trusts, but may change the client’s intentions if there is no federal estate tax to be avoided.

Equally troubling are those documents drafted after the 2001 Tax Act in which the thoughtful attorney included a provision that would apply in the event of an estate tax repeal. As mentioned earlier, there have been many attempts since 2001 to make permanent the repeal of estate taxes. Because of that, some attorneys have included language in their estate planning documents to provide that, “if at the time of my death the federal estate tax does not exist or has been repealed, all such assets shall constitute the Family Trust.” The client may think that his or her documents already provide for the situation we face in January 2010; however, those provisions likely were drafted in contemplation of a possible permanent repeal, not temporary repeal. For example, how would that document be interpreted if estate taxes subsequently were reinstated with the retroactive date? In other words, if a client died in January and there was no federal estate tax at the time of his death, state courts would require the distribution of assets according to the above provision of the client’s estate planning documents. However, if the federal estate tax was reenacted in February or March with a retroactive date back to January 1, 2010, funding under the above provision could cause unintended and significant estate taxes. At a minimum the provision is ambiguous and potentially very expensive in the event that future legislation has a retroactive effective date.

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Conclusion

The solution to the problem created by the temporary repeal of estate tax may have as many answers as there are individual and specific client situations. The Trusts and Estates Group at Johnston, Allison & Hord already has invested considerable effort reviewing potential solutions for our clients. Some clients may be well served with a brief codicil that addresses only the unlikely event that the client dies at a time when there is no estate tax in effect and that tax is not later reinstated with a retroactive date. Equally effective would be a similar codicil that would direct maximum funding to a Family Trust or a GST Trust in the same circumstances, provided that the trust beneficiaries and family harmony make such a funding desirable. However, there will be many clients for whom a simple codicil fix will not work. Family circumstances may dictate that more than one funding provision is needed depending on whether Congress allows the current repeal to stay in effect, whether they extend the 2009 rates and exemptions, or whether we have the 2011 rate and exemption structure under the sunset provision. We strongly recommend that our clients have their estate planning documents reviewed to determine whether the current funding provisions are consistent with their original intent when applied under the existing repealed structure. We have established an efficient system to achieve this review process and believe that most clients can receive tailored guidance about the appropriate measures that must be taken (if any) for a modest fee. If you would like such a review of your estate planning documents, please contact one of the attorneys in the Trusts and Estates Group to request this review.

As always, do not hesitate to contact us if we can provide any additional information or answer any questions. It is our goal to provide useful and helpful guidance at this otherwise confusing time.

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